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ITALY'S AUSTERITY PROGRAM: A PARTIAL REMEDY

The Rumor government's austerity program will ease pressures on the balance of payments over the next twelve months. But it will do little to stem inflation and may contribute to a small rise in unemployment by the end of the year. The labor unions will undoubtedly continue to press the government to relax its program in order to stimulate employment.

THE PACKAGE

The fiscal and monetary measures adopted are the result of a compromise. The Christian Democrats favored tougher measures to curb import demand and inflation, while the Socialists wished to avoid threats to employment and to social-welfare spending. The measures are probably the most stringent now politically feasible in Italy and are certainly stronger and more comprehensive than measures taken by any other West European country to deal with payments problems.

The austerity program aims to boost taxes by $4.7 billion annually while reducing the income tax bite on lower income groups. Most of the added revenue will be used to help finance the Treasury's deficit. Monetary policy will remain relatively tight and will hew to the

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credit ceiling agreed upon with the IMF. As a concession to the Socialists, however, the Christian Democrats have agreed to selective easing of credit to small business. The most important of the new measures are:

- an increase in the corporate income tax from 25% to 30%;
- an increase in advance payments for income tax by self-employed persons from 10% to 20%;
- an increase in the value-added tax on luxury goods from 18% to 30% and on meats from 6% to 18%;
- an increase in the gasoline tax by 25 cents per gallon; and
- an increase in health contributions by employers and employees.

The government's revenue estimate is probably optimistic. Italians are adept at evading taxes, including value-added taxes. Some of the new measures, notably the increase in advance income-tax payments by self-employed persons, will be particularly difficult to enforce despite the government's expressed intention to close tax loopholes. In addition, projected income growth on which the estimate is based may prove to be somewhat weaker than forecast by the government, which is probably relying too heavily on

strong export demand. Overall, revenues from the austerity measures will probably be around 10% less than estimated -- a relatively modest shortfall by previous Italian standards.

Pressures for Change

After protracted discussions among the three major trade-union confederations, Italian labor leaders have stopped short of directly defying the government's austerity program. Instead, they plan to press for changes that are similar to amendments to the austerity program now being pushed by the Communist Party in parliament. Labor's objective is to reduce the impact of the measures on the workers and increase the burden on upper income groups.

The suggested amendments to the program contain the seed of compromise. The government could accede to a number of labor demands without seriously undermining its goal to boost taxes by $4.7 billion. Holding the line on fuel prices, as demanded by the unions, or increasing tax exemptions for lower income groups would not substantially reduce the effectiveness of the austerity program. Instituting higher progressive real estate taxes would add to revenues, although probably at the cost of reduced savings rather than lower consumption.

A few of labor's demands, however, cut to the very heart of the austerity program. Scaling down the increases in utility rates and in employer and employee health contributions, for example, would seriously impair the program's ability to sop up purchasing power.

Balance-of-Payments Impact

The austerity program substantially improves Italy's balance-of-payments outlook. Unless seriously amended, the new measures -- along with the effects of the prior-deposit import scheme -- should cut imports 7.5% over the next twelve months. They should also reduce net capital outflows by bolstering confidence in the economy.

Because orders have already been placed for some months ahead and the impact of direct tax measures will only be felt after a lag, the improvement in the trade account will not show up much before the fourth quarter of 1974. For the year, the trade deficit (imports, c.i.f.) will probably be around $11 billion instead of the $12 billion or more implied by trade flows in the first half of the year. The improvement in the trade account would cut the current account deficit to about $8.0 billion. In the first half of 1975, under the full impact of the program,

the trade deficit could drop to somewhat under $4 billion -- $2 billion smaller than the deficit expected before the austerity program.

The austerity program's contribution to a lower rate of capital outflow should become visible in the second half of 1974. Indeed, tight credit, the euphoria following the government's agreement on the austerity measures, and the announcement that gold could be used as collateral in international borrowing encouraged some Italians to repatriate capital and others to borrow abroad in recent weeks. While Italian investor confidence is unlikely to hold up in the face of continued large trade deficits and waning consumer demand in the months ahead, the current respite should help to keep the overall balance-of-payments deficit to under $10 billion this year.

Because its foreign exchange reserves are perilously low, Italy still must find a way to increase its foreign borrowing if it is to avoid extreme measures such as a large devaluation, import controls, or selling gold. Otherwise, covering the deficit expected during the rest of 1974 alone would exhaust reserves of convertible currencies (under $1 billion) and available IMF resources consisting of the gold tranche ($300 million), the standby

credit ($1.2 billion), and the oil facility ($900 million) -- assuming that all of these funds could be drawn. Roll-over would have to be guaranteed before Italy could use the $4 billion in short-term swaps.

Price Impact

The austerity program will do little over the next twelve months to damp inflation, now running at a 20% annual rate. By covering part of the Treasury deficit, the tax increases will lessen the need to expand liquidity. The measures will also ease demand pressures, but, with considerable spare capacity in the economy, Italy's inflation is more of the cost-push than the demand-pull variety. Deceleration of wage increases and of rises in international raw material prices would do more than the austerity increases to ease Italy's inflation.

The measure increasing value-added tax on some items may even add to inflation. The tax hike will push up consumer prices directly. In addition, the rise in consumer prices will trigger automatic wage adjustments, adding to production costs. Many manufacturers are likely to pass the increased wage costs on to consumers rather than to take a cut in profits.

INVESTMENT AND EMPLOYMENT PROSPECTS

The austerity program could contribute to a steeper drop in investment growth than that now anticipated by the government. If, for instance, manufacturers should decide to accept lower profits in the face of wage increases, the self-financing ability of firms would be impaired. To the extent that the increase in the corporate income tax is collectible, this tax measure will cut into the ability of firms to finance investment. Some of the tax measures, such as increased real estate taxes, will tend to reduce savings rather than consumption, further reducing the funds available for investment.

As investment growth winds down over the next year, unemployment will increase from its current low level of 2.8% of the labor force. Although massive lay-offs are unlikely, unemployment could rise to about 4% of the labor force by mid-1975. In particular, persons entering the labor force for the first time will find jobs scarce.

LABOR'S REACTION

The three labor confederations are united in their dislike of the austerity program. The principal achievement of the program -- an improved balance-of-payments position -- will be relatively meaningless to

the workers whom the unions represent. Most Italians are more interested in their purchasing power at the supermarket than in some abstract concept of national welfare. Even if a government-union compromise emerges from the current debate of the program in parliament, prolonged labor union cooperation is highly doubtful because of the likelihood of rapid inflation and rising unemployment in coming months. The unions have already called for a reappraisal of their position in September.

To ensure labor's acquiesence over the longer term, the government will have to continue making substantial concessions. It will have to follow through on its commitments to improvements in health, housing, and other perennial union concerns. The government would probably have to make uncomfortable budget reallocations to carry out these past promises, however, and the situation will continue to hold the strong possibility of serious labor unrest.

CIA/OER
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